Aircraft Leasing 101
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A Primer

Aircraft Leasing 101 -- A Primer

- **How Do Airlines Acquire Aircraft**
- **Commercial Aircraft Leases**
- **Why Airlines Lease Aircraft**
- **Can the Government Lease Aircraft?**
- **Are Government and Commercial Leases the Same?**

How Do Airlines Acquire Aircraft

There are three general finance avenues for acquisition of new aircraft.

Purchase	The operator buys and owns the aircraft.
Operating Lease (or "True Lease")	A leasing company or its investors owns the airplane and takes the risk on the residual value of the aircraft. The lessor does not acquire any equity in the asset during the life of the lease. With an operating lease the airline does not have to put the airplane on its balance sheet. This is a very important criteria. The lease runs for only part of the life of the airplane. This is truly "rent-a-plane".
Finance Lease (or "Capital Lease")	A long-term mortgage loan under which the lessor takes banking return (acquires equity) over the life of the lease and the aircraft is owned at the end of the lease by the lessee airline.

Commercial Aircraft Leases

- **Operating, or true, lease**
  - A rental agreement where a set periodic payments or (rental amount) are made for a specific period of time, or “lease term”
  - At the end of the lease term the Lessee has three options:
    - Return the asset to the Lessor in like-new condition, except for “ordinary wear and tear”
    - Purchase the asset from the Lessor at its current Fair Market Value
    - Extend or re-lease the asset at its current Fair Rental Value

- **Finance, or capital, lease**
  - The Lessee generally retains some or all of the rights and obligations of asset ownership.
    - These leases are usually financing agreements, much like loans, where the Lessee is often required to make a down payment at the beginning of the lease.
  - At the end of the lease term, the Lessee has the right (and obligation) to purchase the asset for a predetermined and agreed upon price.
    - This price can be a nominal amount, or “bargain purchase option” of one dollar, or can be a significant amount (balloon payment)of say fifty percent of the original cost of the asset.

Why Airlines Lease Aircraft

- **Ease of financing**
- **Can be cheaper**
- **Conserve Cash … (i.e., Capital)**
- **Maintain Flexibility**
- **Obtain Newer/Better Equipment**

Can the Government Lease Aircraft?

- **DoD faces statutory restrictions that impede or prevent it from accomplishing leases on anything close to commercial terms and conditions.**
- **There are three issues (“the three Cs”) with respect to leasing which must be resolved:**
  - **C**ongressional notification
  - **C**ontingent liabilities
  - **C**olor of money

Congressional Notification

- **There is a requirement that any lease over 5 years or lease with significant termination liability be approved in advance by Congress. An aircraft lease would likely qualify on both counts.**

Contingent Liabilities

- **The issue of contingent liabilities consists of two parts**
  - **Insurance/indemnification**
    - If a commercial airline leases an airplane, they are financially responsible to insure the airplane and indemnify the owner (the financier) against loss of the airplane.
    - Since the Government does not buy insurance, the Department assumes the contingent liability which it self-insures. Funds would be required in the event an airplane was lost or damaged.
    - Under current statute, the DoD would be required to "fully fund" this contingent liability which would nullify any financial advantage leasing would provide.
  - **Termination liability**
    - Termination liability covers the financial risk if, for whatever reason, the user wants to return the aircraft before the term of the lease is over. Anyone who has ever leased a car realizes that if they terminate the lease before the period indicated in the agreement, additional cost would be incurred for failure to satisfy the terms of the lease.
    - Termination liability is governed by market forces such as the demand for other customers to lease or purchase these cars. Similar conditions apply to aircraft.
    - If the Government leased airplanes and but later terminated the lease before completion of the terms of the agreement these termination charges would be paid by the United States Government.
    - Thus, here again, this would be a contingent liability which under existing statutes would require "full funding" up front.
- **To allow the government to contract on commercial terms that do not require up front contingent liability funds, 31 USC Sec 1341 and 10 USC Sec 2401 (c) (1) and (2) and (f) must be removed or waived.**

Color of Money

- **Leasing by Government agencies typically is not used for large capital asset programs such as a squadron of freighters**
  - Current statutes require leases to be paid through the Operations and Maintenance accounts.
  - These funds when authorized and appropriated by Congress have a term of one year and expire each fiscal year. Therefore any agreement tied to the Operations and Maintenance accounts have a contractual term of one year.
  - Using the car example, it is less expensive on per day basis to lease a car for a five year period then it is for a five day period. Similarly if the Government were able to enter into longer term agreements the costs of leasing would decrease.
- **Operations and Maintenance funds do not allow the DoD to acquire ownership of an asset with each lease payment.**
  - It is logical that if ownership in an asset increases over time, the overall risk to the financier is reduced. Thus, lease-to-own is the most inexpensive type of lease.
  - Since the DoD eventually wants to own the leased airplanes this is the type of lease which makes most sense.
- **For flexibility in fashioning a lease that fits DoD requirements at the lowest cost, "color of money" restrictions, 31 USC Sec 1301, 31 USC Sec 1347 and 31 USC Sec 1502 must be removed or waived.**

Applicable Statutory Provisions

Statutes that present overlapping constraints that effectively stop the Government from leasing aircraft on an economical basis.

- **31 USC Sec 1301**
  - Restricts use of funds to the specific appropriation purpose, (i.e., aircraft acquisition funds can not be used to support aircraft operations or Operation and Maintenance funds can not be used to acquire even the smallest equity interest in an aircraft.) This effectively eliminates the Government's ability to enter into a lease arrangement on commercial terms.
- **31 USC Sec 1341**
  - Limits the Government's ability to enter into obligations without the liability fully funded at the time of obligation, including contingent liabilities. In leases, there are several contingent and other liabilities – future payments, termination liability, and indemnification – for which it is economical to fund only when the payment is actually due.
- **31 USC Sec 1347**
  - Requires an Agency to spend an appropriation only for the specific purpose for which it is appropriated or authorized. It unduly limits the funding available to fulfill normal lease payment obligations.
- **31 USC Sec 1502**
  - Similar to 31 USC Sec 1347 -- Restricts the term within which an appropriation may be used to pay for the 'bona fide' needs of the period for which they were appropriate. It unnecessarily restricts the source of funding available to meet lease payment obligations.
- **10 USC Sec 2401 (c) (1) and (2) and (f)**
  - Restricts the ability of an Agency to obligate itself to certain contingent liabilities – i.e., termination and indemnification. These contingencies are essential requirements of a lease arrangement that are the lessor's responsibility.

Are Government and Commercial Leases the Same?

- **OMB Circular A-11 describes four types of leases -- each with different "budget scoring rules"**
  - Lease-purchase without substantial private risk
  - Lease-purchase with substantial private risk
  - Capital lease [Finance lease]
  - Operating lease [True lease]
- **Potential leases must be scored against both**
  - Budget Authority
  - Outlays

Summary of Scorekeeping Requirements

Transaction	Budget Authority	Outlays
Lease-purchase without substantial private risk	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease period.	Amount equal to asset cost scored over the construction period in proportion to the distribution of the contractor's costs; amount equal to imputed interest costs recorded on an annual basis over lease term.
Lease-purchase with substantial private risk	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease term.	Scored over lease term in an amount equal to the annual lease payments.
Capital lease [Finance lease]	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease term.	Scored over lease term in an amount equal to the annual lease payments.
Operating lease [True lease]	Amount equal to total payments under the full term of the lease or amount sufficient to cover first year lease payments plus cancellation costs recorded up front	Scored over lease term in an amount equal to the annual lease payments.

Budget Authority Scoring “Penalty”

- **“When an agency is authorized to enter into a lease-purchase contract or capital lease, budget authority will be scored in the year in which the authority is first made available in the amount of the net present value of the Government’s total estimated legal obligations over the life of the contract.”**
  - **Total of all payments expected to arise within the full term of the lease**
  - **All options are assumed to be exercised**
  - **Must include termination/cancellation costs**

Lease Example

- **Typical operating lease rates are between 1% and 2% of the purchase price per month**

- **Assuming $60M aircraft with a 5-year operating lease at 1.5% per month**
  - **$0.9M per month lease price, or $10.8M per year**

- **The actual lease price will be affected by a number of factors, such as:**
  - **Length of term (longer term = lower rate)**
  - **Interest rate at aircraft delivery (typically tied to Treasury rate)**
  - **Pre-delivery payments (similar to construction loan while a house is being built)**
  - **Fair market value (residual value)**
    - **Marketability of asset**
    - **Condition of asset**
  - **Insurance costs**
  - **Indemnification of lessor**

Purchase at End of Lease and Early Buy-Out

- **Typical fair market value is between 60% and 80% of an asset's new purchase price after 5 years**
- **Assuming 70% residual value on a $60M aircraft yields:**
  - **$42M fair market value**
- **Most leases are structured with an option to buy at the end of a lease**
  - **In this case, $42M at end of 5 years**
- **Early buy-out is possible**
  - **Early buy-out price based upon the interest rate and the asset's residual value at time of early buy-out**
- **Buy-outs early in a lease term could be relatively costly compared to buy-outs later in a lease term**

Summary

- **Valid economic reasons exist for commercial airlines to lease aircraft for limited periods of time.**
- **Valid economic reasons exist for the government to lease aircraft.**
- **Some of the economic reasons available to commercial activities are not available to the government (i.e., tax advantages)**
- **The government is subject to additional restrictions not applicable in commercial activities**
  - **Statutory restrictions on sources and uses of monies**
  - **Budget scorekeeping rules**
    - **The principal restriction is the budget authority scoring requirement for the first year of the lease.**
- **US Air Force has recent experience with leasing (C-32 and C-37)**